CHAPTER 17

Partnership Programs

Introduction

In the late 1980s and early 1990s, the Resolution Trust Corporation (RTC) and the Federal Deposit Insurance Corporation (FDIC) became custodians of an unprecedented number of assets from failed banks and thrifts. The agencies therefore had to develop innovative methods to manage and dispose of the assets. One of the RTC's methods, known as the equity partnership, was a joint venture between the public and private-sectors.[1] The equity partnership strategy was designed to yield recoveries with a higher present value than conventional sales methods by capturing the asset management efficiencies and expertise of the private sector while reserving for the FDIC and RTC the profit from improvement in inefficient markets or unpredictable events.

Although not new to either the public sector or the financial services industry, equity partnerships were new to the RTC and the FDIC. Before this period, neither agency had purposefully created partnerships for the management and disposition of assets, even though both agencies had entered into incentive-based contracts that "shared" recoveries through compensation with private-sector parties. However, none of those contracts were created to explicitly retain upside potential resulting from market recoveries or unpredictable events. In addition, none had caused third-party equity capital to be exposed to downside risk as a result of how well the third party managed the agency's assets assigned to it.

During the early 1990s, the RTC created 72 partnerships with a total asset book value of $21.4 billion. The FDIC became a partner in two partnerships holding assets having a book value of approximately $3.7 billion. This chapter reviews the types of

1. The term "equity partnerships" and the derivative terms therefrom pertain to an internal RTC reference to transactions where the RTC entered into partnership and/or trust relationships (as a limited partner) with private sector firms to market and manage assets.

partnerships that the RTC and the FDIC used. It surveys seven different types of equity partnerships in which the RTC acted as limited partner (LP), and reviews the structure and performance of the two Asset Management and Disposition Agreement (AMDA) partnerships in which the FDIC assumed the role of LP.

Background

The concept of having the RTC retain a residual interest in sold assets began in its earliest days.[2] In fact, the RTC strategic plan issued in December 1989 stated that the "RTC should explore ways . . . in which it can participate through passive equity interests in any extraordinary gains that might be realized by the acquirer of the asset." However, it was not until December 1992 that the RTC executed its first joint venture transaction.

By the spring of 1992 several events had occurred that caused RTC management to focus on using partnerships as a disposition vehicle. Continued dissatisfaction with the pace of nonperforming asset disposition through customary methods, internal staffing constraints, difficulties in running a large asset management contracting program, pressure not to "sell at the bottom of the market," and the initial success of the RTC's securitization program all contributed to an environment that fostered the development of equity partnerships.[3]

However, arguably the most significant factor was the anecdotal evidence that investors purchasing large RTC asset portfolios leveraged their equity with financing from major financial institutions or by securitization within six months after acquisition. That indicated that the investors were quickly able to establish predictable cash flows from the assets, either by converting them to performing status or by obtaining payoffs that met the investors' required rates of return. It also indicated that the RTC could obtain higher recoveries by offering such leverage to investors. Given the apparent success that asset portfolio purchasers achieved, RTC staff concluded that it would obtain greater returns if it held a residual capital position in a structure that provided investors a leveraged return. The vehicle for achieving that position was the equity partnership program.

Structure of the Equity Partnerships

Under the equity partnership program, the RTC established joint ventures between itself acting as LP and a private-sector investor, usually a joint venture between an equity

2. On December 31, 1995, the RTC ceased to operate and its functions were legally taken over by the FDIC. All of the equity partnerships originated while the RTC was in operation. To avoid confusion, all references to the limited partner, both before and after December 31, 1995, will generally be expressed as the RTC.

3. See Chapter 13, Auctions and Sealed Bid Sales, and Chapter 16, Securitizations.

investor and an asset management company, acting as general partner (GP). The RTC contributed asset pools (usually subperforming loans, nonperforming loans, and real estate owned [REO]) and arranged for financing of the partnership, while the GP invested equity capital and asset management services. The financing terms required that cash proceeds generated from the liquidation of assets be applied first to the retirement of the debt (usually bonds held by the RTC).[4] After the debt was paid in full, the partners generally split the remaining proceeds according to the percentage of ownership each partner held. Thus, unlike a direct asset sale, the RTC retained a residual interest, which entitled it to receive some proceeds at closing and, as the assets were liquidated, to receive the remainder of the proceeds periodically throughout the life of the portfolio.

The RTC attempted to align the financial incentives for the LP and GP of the partnership to ensure that the assets in the portfolio would be liquidated in the most cost-effective and mutually profitable manner. RTC staff assumed that the investor's primary incentive would be to maximize the return on its investment. That incentive, by itself, was similar to the agency's objective of maximizing recovery from the asset. However, RTC staff were concerned that unless the partnership was structured properly, the GP could achieve its objective without a commensurate return to the RTC.[5] Factors considered in structuring the partnerships included the size of the asset portfolio, the type of asset, the expected duration of the partnership, the amount of leverage to provide the investor, and the investors' expected equity capital rates of return.

Although the various types of equity partnerships have different structures, they share many common features. Some of those include the following:

- Proceeds from the disposition of the underlying equity partnership assets were distributed pro rata to both partners. Neither partner held a senior nor a subordinate position.
- All deals required the GP to acquire its interest in the partnership with cash. The RTC's capital contribution was the value of its share of assets conveyed to the partnership.
- The RTC provided funding for interim financing, or working capital, for the partnership.
- The representations and warranties the RTC provided as seller in the equity transactions were limited in their provisions compared with the terms of "normal"

4. In actuality, certain fees were subtracted before proceeds were applied to debt payment, such as fees incurred to create and sell the bonds, and certain asset management and liquidation expenses that were subject to a cap.

5. The RTC had intensively studied the Federal Savings and Loan Insurance Corporation (FSLIC) assistance agreements and concluded that conflicting incentives to prolong the disposition of assets were created when asset managers were given yield subsidies or reimbursement of holding costs rather than compensation derived from asset sales.

financial industry and typical RTC transactions.[6]

- Each agreement prohibited the GP from certain actions, including self-dealing, unless preapproved by the RTC. The agreements prohibited affiliate transactions in the equity partnerships structured as trusts, but permitted them, with notice, in the Multiple Investor Fund (MIF) and Judgments, Deficiencies, and Charge-offs (JDC) partnerships. (The MIF and JDC partnerships are discussed later in this chapter.)

- The GP had full delegated responsibility to conduct the partnership's day-to-day business affairs, such as managing, servicing, and disposing of the assets in the portfolio. The partnership agreement allowed for subcontracting management, disposition, and support functions, if necessary.

- The GP was required to contract with an external accounting firm to perform an annual audit and certify the partnership's financial statements.

- Each partnership reimbursed certain GP expenses that were specified in the agreement. Reimbursement of those expenses was contingent upon the GP's compliance with the partnership's policies.

- The GP had the right to transfer its interest in the partnership upon approval of the LP. The LP, however, had the right to transfer its interest without the GP's consent.

- The LP had the right to remove the GP for cause upon breach of certain covenants and if certain events occurred. In the event of such a removal, the LP had the right to appoint a new GP.

The Evolution and Types of Equity Partnerships

The 72 equity partnerships the RTC created from December 1992 through October 1995 included assets with a total book value of $21.4 billion and a derived investment value (DIV) of $3.8 billion.[7] The following discussion provides a summary of each of the seven types of partnership transactions.

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6. For example, although the representations and warranties given by the RTC in the Multiple Investor Fund (MIF) transactions are comparable to those given in whole loan or portfolio sale transactions, the recourse against the RTC is more limited. With most representations, the RTC would not be obligated to pay losses unless the MIF itself did not have sufficient funds to make a payment on its rated debt securities. In other words, the RTC's representations and warranties apply only to the MIF's debtholders and not to its equityholders, and the MIF's equity must be exhausted before the RTC must pay a claim.

7. The DIV is an internal RTC reference to a discounted cash flow valuation for nonperforming asset pools. The DIV is discussed more thoroughly later in this chapter. A DIV was not performed for any of the assets in the JDC program, therefore the DIV total represents the sum of the other six equity partnership types.

N Series

In December 1992, the RTC created the first type of equity partnership, known as the Nonperforming Loan Series for large investors, or N Series. The RTC consummated six N Series transactions, each with an estimated life of five years. Established to move a large volume of identified assets in a single transaction, the average N Series partnership transaction had a book value of $464 million and a DIV of $220 million and was targeted for the institutional investor.

The N Series portfolios were made up of commercial and multi-family subperforming and nonperforming mortgage loans. The RTC placed more than 2,600 loans with a book value of approximately $2.8 billion into the N Series transactions. Those assets had a total DIV of $1.3 billion. The asset portfolios of the N Series transactions were generally geographically diverse (compared with the later S Series, in which assets were grouped regionally).

The GP in the N Series transactions, which were legally structured as trusts, usually consisted of an investor teamed with an asset management firm.[8] The RTC sold an asset portfolio to the trust in exchange for cash, Class A certificates representing a 49 percent interest in the trust, and Class B certificates representing the remaining 51 percent interest. The GP (a large investor) purchased the Class A certificates from the RTC. Those certificates provided rights to the investor similar to those that a general partnership interest would have provided in a partnership. The RTC retained the Class B certificates.

The trust issued bonds to third-party institutional investors through open market transactions and used proceeds from the bonds to purchase the assets from the RTC.[9] A total of $974.9 million in bonds were issued for the six N Series transactions. Typically, the amount of bonds issued by the trust represented 60 percent of the value of the trust assets before bond issuance. As assets were liquidated, the trust first used proceeds to retire the bonds issued, then distributed remaining proceeds proportionally to the Class A and B certificate holders for the remaining 40 percent value of the trust.

By issuing bonds to third-party investors in the transactions, the RTC obtained several benefits. Most importantly, the RTC received large cash inflows at a time when the RTC needed funds for operations. Secondly, the amount of capital that prospective investors needed to place at risk was reduced and leveraged, thereby creating more interest and competition. In addition, rating agencies and bondholders provided additional

8. Equity partnerships structured as trusts shared some common characteristics. For example, the partners own the trust, and the trust has title to the assets. An independent trustee acts on behalf of the trust and takes direction from the Class A certificate holder (GP), as defined in the legal documents. The trust is a legal entity that accommodates the issuance of securitized debt more readily than does a partnership structure.

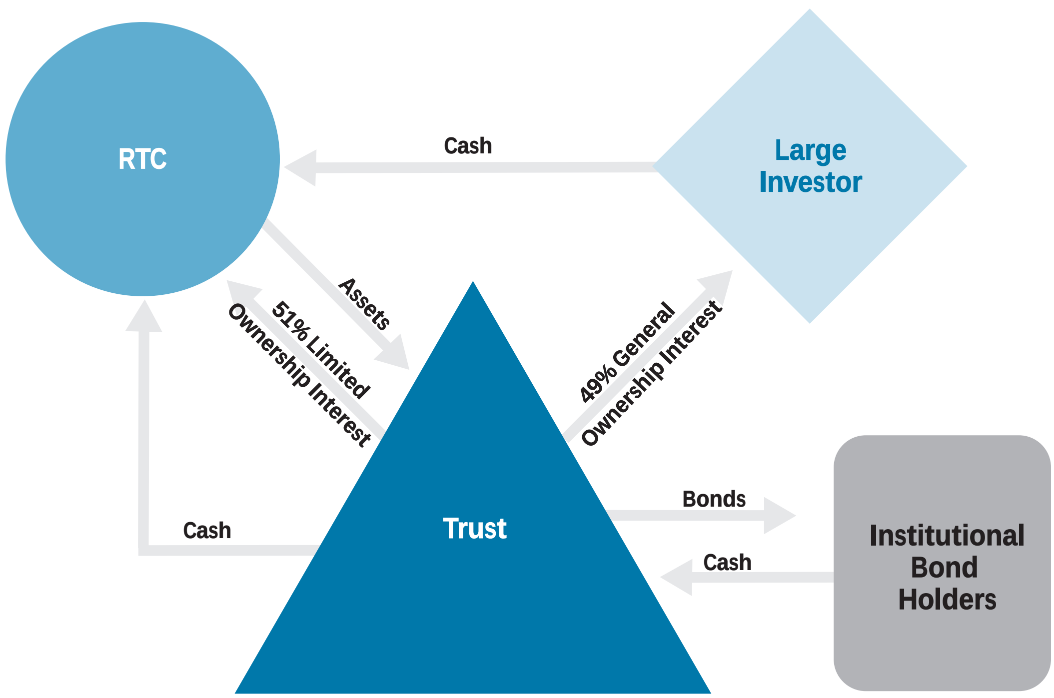
9. In accordance with general market practice, the trust issued and administered the bonds through a separate third-party trustee.

scrutiny to the GP's performance. However, those benefits did increase the execution cost of the transaction. Chart I.17-1 illustrates the structure of the N Series trust.

After a short time, one phenomenon soon became evident: the GP generated cash so quickly from the asset portfolio that the bonds were paid off much earlier than anticipated. For example, the original maturity date for each of the bonds was 10 years from the transaction closing date. All of the bonds were retired, however, after just 28 months, with the average bond being retired in 21 months. Because the bonds were retired so quickly, the RTC determined that, given the additional processing time, transaction expense, and cost of borrowing, selling bonds on the open market was not effective. That fact led to the development of the next generation of equity partnerships, starting with the S Series in September 1993 (discussed later in this chapter), in which bonds were issued by a trust, but were held by a trustee on behalf of the RTC.

Chart 1.17-1

Structure of N Series Trust



Source: FDIC Division of Resolutions and Receiverships.

MIF Series

In January 1993, the RTC completed two Multiple Investor Fund partnerships, also known as the MIF Series, which followed the N Series. Although each had a specified term of 20 years, the GPs estimated that their portfolios would be liquidated in considerably less time. Also designed to sell a large volume of assets in a single transaction, the two MIF transactions included more than 1,000 loans with a book value of $2 billion and a DIV of $982 million. However, the MIF Series differed from the N Series in that investors did not bid on specifically identified assets.

After a widely advertised and highly competitive process, the RTC selected private-sector entities (MIF sponsors) to become the GPs for the MIFs on the basis of their bids for a "blind pool" of unidentified assets that met certain parameters regarding asset size, asset type, and location.[10] To compensate for having to accept virtually all assets delivered at closing, the partnerships had an absolute "Kick Out Right" to require the RTC to repurchase, within a specified period of time, certain assets determined by the GP to be unacceptable. The RTC's requirement to repurchase assets under the terms of the Kick Out Right was limited to 10 percent of the partnership's assets as measured by DIV. Although the MIF partnerships were bid in a competitive environment, some terms of the agreement were negotiated later with the winning bidder. The typical underlying assets contributed by the RTC into the MIF partnerships included commercial and multi-family performing and nonperforming mortgage loans and some REO.

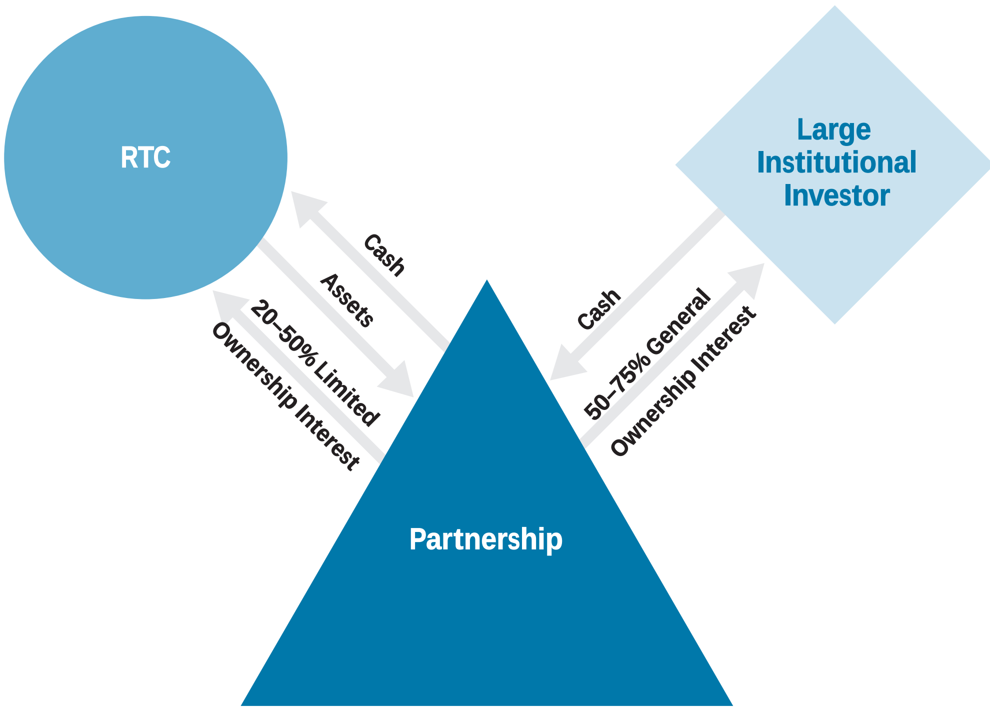
The MIFs were legally structured as partnerships. The RTC acted as LP and owned a 25 percent to 50 percent partnership interest, while the GP held a 50 percent to 75 percent interest. Although the MIFs did not formally issue bonds, they did have a bond-equivalent debt feature in which the bond-equivalent debt was secured by the GP's interest in the partnership.[11] The RTC held the note for that debt. The MIF's first priority for distributing the proceeds was to repay the note due to the RTC; it would then distribute the rest of the proceeds pro rata on the basis of the original ownership interest for the remaining value of the partnership's portfolio. The bond equivalents for the two MIFs totaled $497 million; all were retired within 26 months. Chart I.17-2 illustrates the structure of the MIF partnership.

10. Although only two MIFs were completed, three MIFs had actually been slated. One of the MIF sponsors was forced to back out at the last minute when its third-party financing fell through. That was one of the situations that pointed to the need for RTC seller financing to help avoid repeating such a predicament in the future.

11. Certain representations and warranties made by the RTC were for the benefit of prospective bondholders had the RTC interim financing been replaced by a securitization. Because the interim financing was retired through internal cash flows rather than through a securitization, the bondholder representations never went into effect.

Chart 1.17-2

Structure of MIF Partnership



Source: FDIC Division of Resolutions and Receiverships.

Land Funds

In July 1993, the RTC created land funds, the third type of equity partnership. Three land fund offerings spawned 12 partnerships. Designed to share in the profit from long-term recovery and the development of land, each partnership had a defined term of 30 years. The offerings had multiple pools of performing and nonperforming loans and real estate in various stages of development, generally either undeveloped or partially developed land. The 12 land funds included more than 815 assets with a book value of $2.2 billion and a DIV of $641 million. The average land fund transaction had a book value of $185 million and a DIV of $53 million. The RTC targeted the land fund for the smaller local investor to attract as wide an audience as possible. [12]

12. Catering to the small investor started with the land fund transactions and continued to be a strong factor in future equity partnership offerings, particularly the S Series.

The land fund transactions had the legal structure of a partnership. The GP was usually an asset manager and developer, which was a unique combination of skills for a GP in the equity partnership program. Such expertise was necessary to maximize the value of the land, which was among the most deeply discounted assets in the RTC's portfolio.

In the land fund transaction, the partnership bears the cost of developing the land and deducts expenses before distributing proceeds to the partners. The GP has the right and duty to enhance the value of the partnership. Should the cost to develop a certain asset exceed the limitations of the partnership, the GP can seek third-party sources for additional funding. The GP must secure the LP's consent on that additional financing before the GP can go forward; if the LP withholds consent, the GP must reconsider its plans for that asset.

Given the nature of the assets, the RTC added a special feature to the marketing of that type of partnership that allowed investors flexibility and options. At closing, the GP could choose to contribute 25, 30, 35, or 40 percent of equity and assume a like ownership percentage. The RTC as LP would automatically own the inverse interest percentage.

As assets are liquidated, proceeds are applied first to operating expenses and then to the repayment of the original capital investment amounts pro rata to the GP and LP. After the original investments are recouped, the additional proceeds are then split 50-50 between the GP and LP (to give the GP an incentive to liquidate the rest of the portfolio) for the remaining life of the portfolio and the value of the partnership. Chart I.17-3 illustrates the structure of a land fund partnership.

S Series

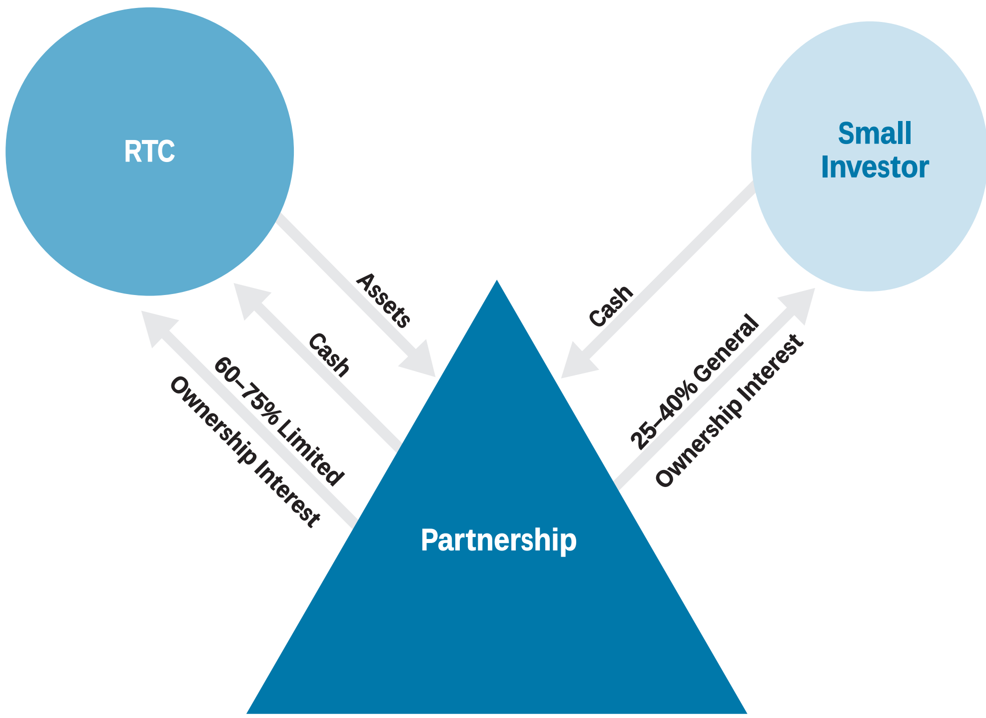
Starting in September 1993, the RTC began the Small Investor Series, or S Series, equity partnerships. The S Series was specifically targeted for smaller investors as opposed to the N Series or MIFs. Although the assets included in the S Series were of the same individual size and type as in the N Series (typically, commercial and multi-family subperforming and nonperforming mortgage loans), the pools were smaller to enable the smaller investor to participate. The RTC contributed more than 1,100 loans with a total book value of approximately $1 billion and a DIV of $466 million to those partnerships. The average S Series transaction had a book value of $113 million, a DIV of $52 million, and an estimated life of four years. Nine S Series transactions were completed.

The need to develop the S Series arose from the perception that the RTC was structuring its sales so that only firms with substantial capital would be eligible to compete. Starting in 1993, the RTC gave small investors increased importance by reaching out to them through advertising and designing transactions that conveyed smaller asset portfolios. The change in strategy ultimately worked in the RTC's favor because it opened up the pool of potential investors, resulting in greater competition and higher sales prices.

A unique characteristic of the S Series is that the assets were grouped geographically so that the small investor would have an easier, less costly due diligence process. The following information from the RTC brochure "Small Investor Program" highlights differences between the S and N Series transactions:

Chart 1.17-3

Structure of Land Fund Partnership



Source: FDIC Division of Resolutions and Receiverships.

- The transaction would range in size from $25 million to $60 million in market value. That size required that investors provide only $4 million to $9 million in private equity, rather than the $30 million to $70 million required for the N Series.
- Some of the debt created from the S Series would be retained by the RTC, whereas with the N Series it was all sold to investors.
- The financial adviser would qualify servicers on the basis of their ability to manage assets rather than on rating agency evaluations, which can be lengthy and cost-prohibitive for small firms.

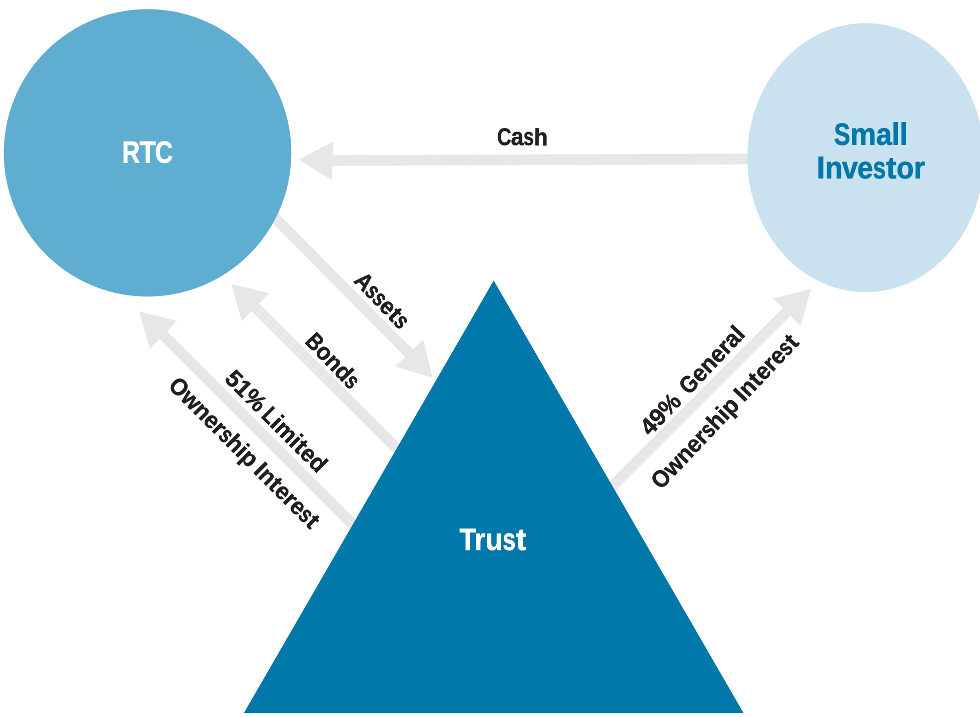
The S Series transactions were legally structured as trusts, which issued bonds that were held by a trustee on behalf of the RTC. The bond debt typically represented 60 percent of the value of the trust. Altogether, the trust issued bonds in the amount of $284.3 million for the nine S Series trusts. The original maturity date of each bond was 10 years after the transaction closing date. All bonds were retired after 22 months, with the average bond being retired within 16 months. The GP (a small investor) owned a 49 percent interest in the trust through its ownership of all outstanding Class A certificates. The RTC, acting as LP, held Class B certificates and owned a 51 percent interest in the trust. As assets were liquidated, the proceeds were used first to pay off the bonds until they were retired. For the remaining 40 percent value of the trust, the proceeds were then distributed with 51 percent going to the LP (Class B holder) and 49 percent to the GP (Class A holder) until all assets were liquidated. Chart I.17-4 illustrates the structure of the S Series trust.

Judgments, Deficiencies, and Charge-offs

In December 1993, the RTC initiated the JDC equity partnership program and set up 30 partnerships. The JDC agreements specified a five-year term, with either partner having the option to terminate the agreement after the third year and on each anniversary thereafter, providing that six months' notice was given. Because the assets the RTC contributed to the partnership were impaired by legal constraints or were unsecured and

Chart 1.17-4

Structure of S Series Trust



Source: FDIC Division of Resolutions and Receiverships.

of poor quality, the JDC partnerships typically had a GP that included a firm with collection experience.

The JDC program is the only type of equity partnership that allowed assets to be transferred to the partnerships not only at the beginning of the partnerships but also throughout their life, as pools became available.[13] As of September 30, 1997, the JDC partnerships had received approximately 137,000 assets with a total book value of $12.4 billion, which were small balance assets with a book value of approximately $291 million and JDC assets with a book value of about $12.1 billion.[14] The average JDC partnership's book value was equal to about $414 million.

The JDC equity partnership transactions were legally structured as partnerships. The RTC's contribution to the partnership was at an established value of 1 percent of the book value of the JDC assets and of 20 percent of the book value for the small balance assets. Because the true value of the assets to be transferred by the RTC into the various partnerships could not be accurately determined, the RTC established a policy at the outset of the JDC program to value the asset contributions in that manner. The RTC based the valuation methodology loosely upon the RTC's historic recovery rates on JDC assets disposed of through auctions and sealed bids.

The GP contributed cash equal to 0.0101 percent of the assets' book value for JDCs and 0.2 percent of the assets' book value for small balance assets. The first 10 percent of gross collections from the JDCs resolved by the partnerships were placed in a reserve account to cover certain qualified expenses (such as the LP's portion of costs to establish the partnership, annual audit fees, and asset expense reimbursement requests approved by the LP). Remaining collections were distributed with 80 percent going to the LP and 20 percent to the GP for small balance assets and split 50-50 for JDC assets.

The reserve account arrangement was unique to the JDC program. The partnership was generally prohibited from selling assets except during the last six months before the termination of the partnership, unless the LP approved an exception. If, at the end of the partnership, the RTC had not recouped its initial investment, it was entitled to receive 99 percent of the funds remaining in the reserve account. If the RTC had recovered its original investment, the reserve account was to be split 50-50 between the LP and the GP after qualified expenses had been paid.

13. The JDC agreements specified that the partnerships were to receive initial transfers of asset pools in the amount of either $100 million or $300 million. After the partnerships received their specified allocation, however, additional transfers of asset pools were reserved for only the most qualified partnerships remaining. The LP ranked the partnerships on a regular basis, primarily by asset disposition performance and compliance of the GP with the terms of the agreement.

14. At the beginning of the JDC program, small balance assets that came from the RTC had to be no larger than $100,000 in book value to qualify for inclusion in the JDC partnerships; that amount was amended in the fourth quarter of 1995 to be no larger than $500,000. Although the FDIC began transferring JDC assets that came initially from the FDIC into the partnerships in 1996, no small balance assets of any size that originated from the FDIC were ever allowed into the JDC program. In addition, all JDCs, whether they came initially from the RTC or the FDIC, could be included in the JDC program without regard to their book value.

The GP was expected to fund all expenses of the partnership except those qualified expenses designated to be paid out of the reserve account, as noted above. The partnership agreement required the GP to maintain a minimum balance in the reserve account of at least $100,000 at all times. If the initial capital contribution in the reserve account was less than $100,000, the GP could not use the reserve account funds until the $100,000 minimum level was met; the GP then had to maintain that minimum level.

Because the GP had been required to put up so little of its own money to establish an equity position in the partnership, the qualified expenses of the partnership could quickly erode the reserve account to the required minimum level. A provision in the JDC agreement allowed the GP to submit a request to the LP to approve the use of reserve account funds to cover asset-related expenses under certain conditions, for example, if the estimated recovery for an asset was no less than $100,000 and the actual expenses were greater than 30 percent of the actual recovery. If those conditions were met, the LP could approve payment from the reserve account in an amount determined to be the lesser of either 80 percent of actual expenses or 80 percent of the estimated expenses (or whatever was determined by both partners to be in the best interest of the partnership). Under the JDC equity partnership structure, the LP was under no obligation to approve the GP's reimbursement requests. That situation illustrated a misalignment of the financial incentives between the partners. Chart I.17-5 illustrates the structure of the JDC partnership.

SN Series

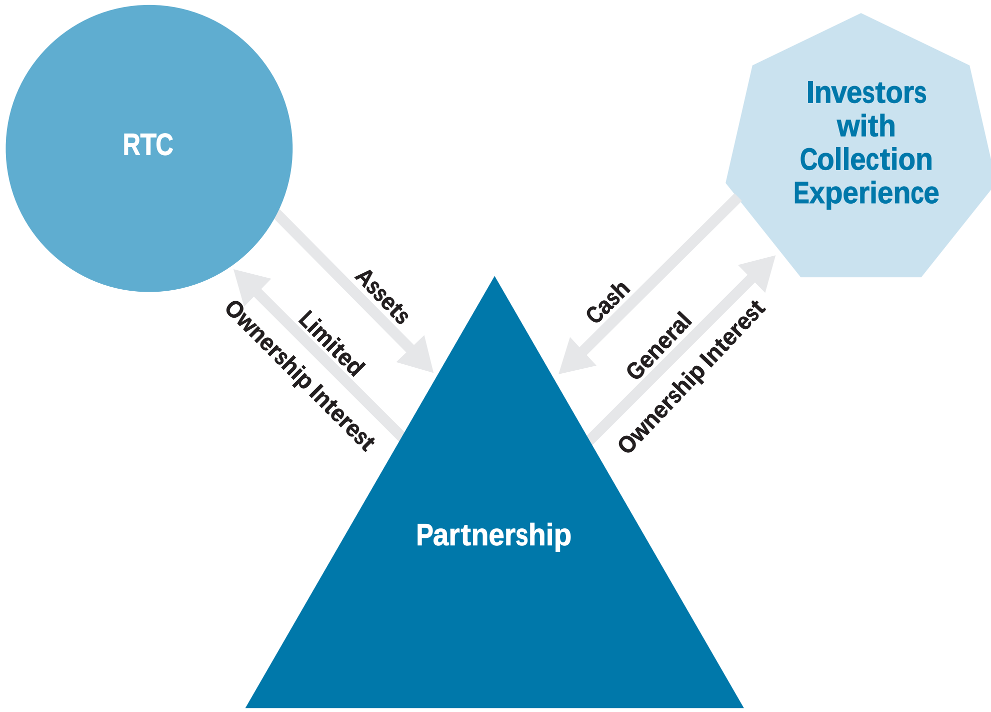
In August 1995, the RTC launched the sixth type of equity partnership, the SN Series. Five SN Series transactions were completed with an estimated life of three years. The average book value of an SN Series transaction was $88 million with a DIV of $45 million. The SN Series combined aspects of the S and N series so that the RTC could market the SN Series to both smaller and larger investors. The unique feature of the SN Series equity partnership type was that investors could bid either on certain pools or on all of the pools as a whole. The RTC would accept that combination of bids (or bid) that resulted in the highest recovery.

Typical underlying assets for the SN Series were nonperforming commercial mortgage loans. (In comparison, both the S and N series held nonperforming commercial and multi-family mortgage loans.) The RTC contributed more than 500 loans to the SN Series transactions, which had a total book value of $440 million and a DIV of $225 million.

Like the S Series, the SN Series transactions were legally structured as trusts, which issued bonds that were held by a trustee on behalf of the RTC. The bond debt typically represented 60 percent of the value of the trust. The GP (either a large or a small investor) owned 49 percent interest in the trust and was a Class A certificate holder. The RTC, acting as LP, held Class B certificates and owned a 51 percent interest in the trust. As assets were liquidated, the trust first used the proceeds to pay off the bonds until they

Chart 1.17-5

Structure of JDC Partnership



Source: FDIC Division of Resolutions and Receiverships.

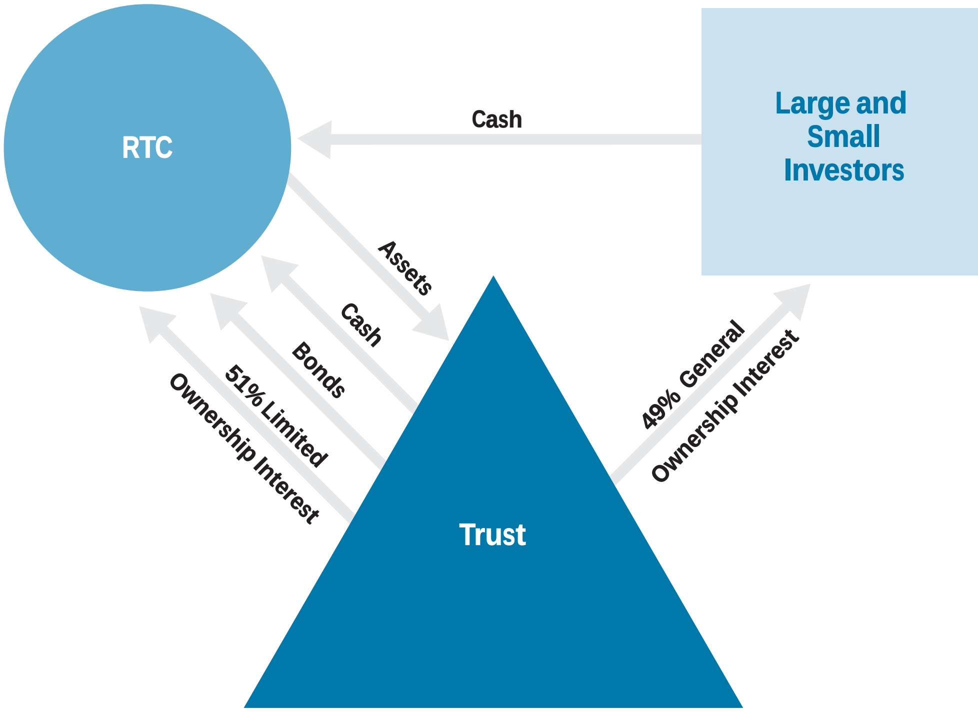
were retired. For the remaining 40 percent value, the trust distributed proceeds with 51 percent going to the LP (Class B holder) and 49 percent to the GP (Class A holder) until all assets were liquidated. A total of $135 million in bonds were issued for the five SN Series transactions and held by the RTC. As of August 1997, all bonds have been retired except for one bond issue with an outstanding balance of $5.5 million. Chart I.17-6 illustrates the structure of the SN Series trust.

NP Series

The seventh equity partnership type, the Nonperforming Loan Series for small investors, or NP Series, began in August of 1995, and eight NP Series transactions were completed. They were geared toward the small investor and were marketed near the RTC's closing date (December 31, 1995). The NP Series, which was the smallest of all the equity partnership types, had an average book value of $67 million and a DIV of $15 million. Each transaction had an estimated life of three years.

Chart 1.17-6

Structure of SN Series Trust



Source: FDIC Division of Resolutions and Receiverships.

The NP Series transactions were the hardest-to-sell assets in the RTC's portfolio, because they were the true nonperforming loans. Typical underlying assets included (1) nonperforming land loans and land REO, (2) unsecured loans or loans secured by non-real estate collateral (such as business loans), and (3) nonperforming commercial real estate and REO (commercial and multi-family). The RTC contributed more than 623 loans to those eight transactions. The loans had a total book value of $537 million and a DIV of $119 million.

The NP Series transactions were legally structured as trusts. The private-sector bidder was given the option to bid at 20, 30, 40, or 50 percent levels of equity ownership in the trust. That option allowed bidders to choose the amount of capital they wished to expose to the perceived risk/return characteristics of the portfolio. Choosing a lower versus a higher percentage of ownership, however, did not "leverage" the buyer's equity investment. The RTC sold its asset portfolio to the trust in exchange for cash, Class A certificates representing 30 percent to 50 percent interest in the trust (because no bids were successful at the 20 percent ownership level), and Class B certificates representing the remaining 50 percent to 70 percent interest in the trust. The GP (a small investor) purchased the Class A certificates from the RTC, and the RTC retained the Class B certificates.

The trust issued bonds that were held by a trustee for the RTC.[15] As assets were liquidated, the trust used the proceeds first to pay off the bonds until they were retired, and then distributed the remaining proceeds to the LP and GP pro rata for the remaining value of the trust. Only three of the eight NP Series equity partnerships issued bonds. For the three partnerships, $33.6 million in bonds were issued with an original maturity of 10 years. All of the bonds, however, were fully retired after only eight months. Chart I.17-7 illustrates the structure of the NP Series trust.

Measuring the Success of the Partnerships: Recovery Results

The success of any program should be determined by whether it achieved its objective. As stated in the introduction to this chapter, the equity partnerships were established to obtain higher present value recoveries than conventional methods could by capturing the management efficiency and expertise of the private sector, while reserving for the RTC potential profit from the improvement of inefficient markets or unexpected events. That asset management and disposition strategy also allowed the RTC to move a large number of assets off of its books. This section examines two indicators that can be used to determine the achievement of that objective.

Recovery on Book Value

A common tool that the RTC and FDIC management use to measure sales results is the net rate of recovery on the book value (recovery rate) of the assets. That analysis is attractive because recovery rate information is available on virtually every transaction.

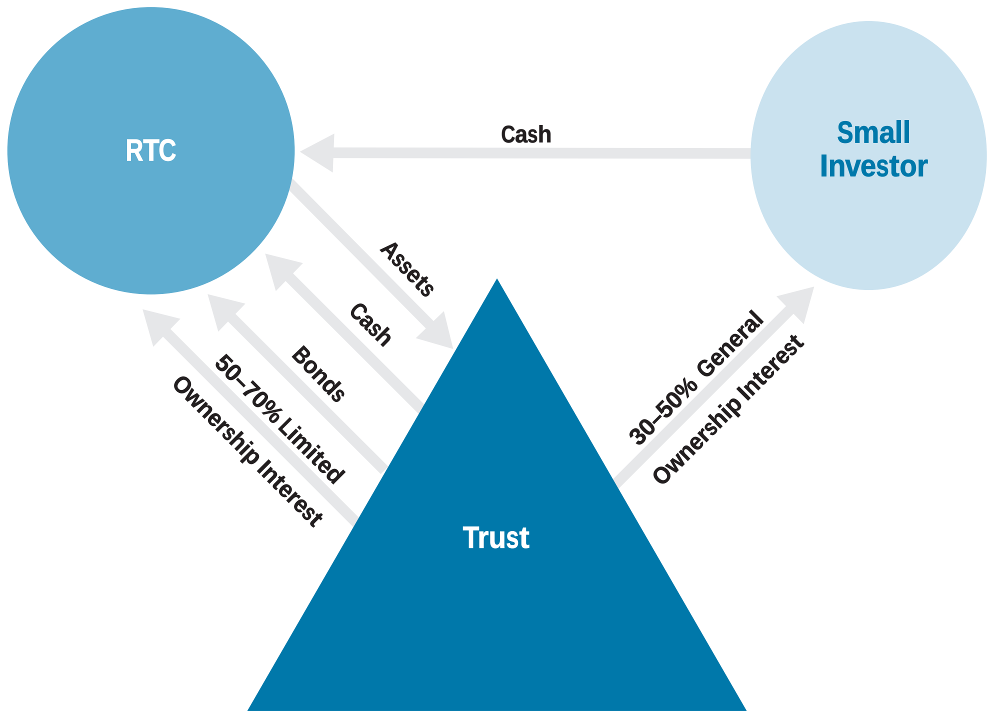
The recovery rate is calculated as the net proceeds from the transaction divided by the initial book value of the assets. When comparing the recovery rates achieved by equity partnerships holding commercial and multi-family real estate assets with other disposition strategies employed by the RTC, the performance of the equity partnerships outpaced all other strategies. Although the recovery rates for equity partnerships holding land and construction assets were competitive with other RTC strategies (see table I.17-1), when the recoveries of those same equity partnerships are compared to the DIV, their recovery rates are superior (see table I.17-2).

The recovery rate analysis, however, has some inherent shortcomings. For instance, (1) asset characteristics among comparison pools may not be similar enough for recovery rates to be a meaningful indicator for performance, and (2) the book value derived

15. No bonds were issued for the first five of the eight NP Series equity partnerships.

Chart 1.17-7

Structure of NP Series Trust



Source: FDIC Division of Resolutions and Receiverships.

from accounting records may reflect historical prices adjusted inconsistently from asset pool to asset pool for such items as expenses, income, and legal costs. Considering the first and second shortcomings separately and especially together, viewing the book value approach alone can result in misanalysis. However, when employed with an analysis of recovery on estimated value, recovery on book value can validate overall performance.

Recovery on Estimated Value

Derived Investment Value is an RTC valuation methodology similar to discounted cash flow methodologies typically used by the financial industry to value nonperforming loans. In general, the DIV is a means of calculating the present value of future cash flows expected from liquidating a nonperforming asset net of expenses. It was used to establish reserve prices for portfolio (bulk) sales of nonperforming assets.

Because DIV is a valuation methodology that was used for various types of RTC disposition strategies, a comparison of recovery as a percentage of DIV among RTC

Table I.17-1

Recovery Rates Achieved by the RTC
RTC Equity Partnerships Compared by Asset Type
Stated As a Percentage of Book Value

($ in Millions)

Disposition Strategy for Commercial/Multi-Family Assets	NPV of Actual and Projected Collections*	Book Value	Collections as a Percentage of Book Value
SN Series	**$254**	**$440**	**58**
N Series	**1,573**	**2,782**	**57**
S Series	**571**	**1,019**	**56**
MIF Series	**995**	**2,034**	**49**
Auctions	211	466	45
MAST (Multi-Asset Sales Transactions) Seller Financing	887	2,053	43
Sealed Bids	3,132	7,472	42
Disposition Strategy for Land and Construction Assets			
Auctions	$122	$259	47
Sealed Bids	122	407	30
NP Series	**145**	**537**	**27**
Land Funds	**592**	**2,218**	**27**
MAST Seller Financing	279	1,057	26

Equity partnerships are shown in bold type. The NP Series also contained commercial loans. The RTC data regarding other non-equity partnership transactions is as of June 30, 1995, which was the last time the RTC reported those types of transactions.

* RTC recoveries for the equity partnerships are net of expenses, which are paid by the partnership before distribution. Those recoveries were discounted at a rate representing the three-year Treasury constant maturity rate per Federal Reserve Economic Data to date for actual bond and equity proceeds received through June 30, 1997. Projected bond and equity proceeds from July 1, 1997, through each transaction's estimated termination date were discounted at 8 percent. Termination dates are based on the transaction-specific business plans received from each GP managing an equity partnership. Those recovery rates reflect financing provided by the RTC to the GP, if applicable. The RTC disposition strategies of auctions and sealed bids were done on a cash basis. The MAST seller financing recovery represents net proceeds received at closing and the face value of the note.

Source: FDIC Division of Resolutions and Receiverships (equity partnerships) and RTC Division of Asset Management and Sales (other transaction types).

Table I.17-2

Recovery Rates Achieved by the RTC
RTC Equity Partnerships Compared by Asset Type
Stated As a Percentage of Derived Investment Value*

($ in Millions)

	NPV of Actual and Projected Collections*	DIV	Collections as a Percentage of DIV
Disposition Strategy for Commercial/Multi-family Assets			
S Series	**$571**	**$466**	**123**
N Series	**1,573**	**1,321**	**119**
SN Series	**254**	**225**	**113**
MAST Seller Financing	887	795	112
MIF Series	**995**	**982**	**101**
Sealed Bids	3,132	3,830	82
Auctions	211	NA†	NA
Disposition Strategy for Land and Construction Assets			
NP Series	**$145**	**$119**	**122**
Land Funds	**592**	**640**	**93**
MAST Seller Financing	279	306	91
Sealed Bids	122	163	75
Auctions	122	NA	NA

Equity partnerships are shown in bold type. The NP Series also contained commercial loans. The RTC data regarding other non-equity partnership transactions is as of June 30, 1995, which was the last time the RTC reported those types of transactions.

* For transactions conducted before March 1994, the RTC's DIV methodology permitted the use of discount rates ranging from 14 to 25 percent for nonperforming assets. After March 1994, expected cash flows were discounted at rates between 12 and 22 percent.

† Not applicable.

Source: FDIC Division of Resolutions and Receiverships (equity partnerships) and RTC Division of Asset Management and Sales (other transaction types).

disposition strategies can reflect the performance of the equity partnerships in comparison with the other strategies. This comparison shows that the equity partnerships had better overall recoveries relative to DIVs. See table I.17-2 for a summary of recovery rates achieved by the RTC.

Like the recovery on book value analysis discussed previously, a number of potential issues could limit the value of using recovery on estimated performance. For example, although DIV is calculated using a narrow range of standard assumptions, the valuation process is still vulnerable to the subjectivity of the various analysts performing the calculations. In addition, the DIV calculations for assets in the S and NP Series transactions were calculated using a revised DIV methodology that generally would result in a higher valuation estimate than would the DIV methodology used for the other transactions.

Although the above analyses attempt to quantify the recoveries experienced from both equity partnerships and traditional liquidation methods, the limitations inherent in the analyses allow for only broad, summary observations. However, taken together, the analyses seem to indicate that the equity partnership structure achieved superior recoveries for the RTC.

It is important to note that certain items, such as the RTC's cost of oversight for the equity partnership program, have not been included in the recovery analyses. Other items, such as the expenses associated with the cost of GAO and FDIC OIG audits and reviews, have not been included for any of the RTC programs. To what extent such expenses vary for particular equity partnerships, partnership types, or the equity partnership program as a whole is unknown.

Evaluation of the Results of the JDC Partnership Program

The RTC deliberately did not value JDCs before their sale to JDC partnerships to avoid the cost of due diligence and valuation on assets that inherently have little or no value. Accordingly, the only method to evaluate recovery performance is to compare their initial contribution value of 1 percent of book value with the current estimate of projected proceeds. Table I.17-3 shows the anticipated recovery rate calculation for the JDC program as of September 30, 1997.

An analysis of the JDC program recovery rate suggests that the RTC may not expect to recover its initial investment. This analysis does not take into account, however, the costs that would have been incurred either directly or indirectly had the assets been held and managed by the RTC directly, including the cost to perform due diligence on the assets to determine whether they were collectible or had value. In fact, approximately 50 percent of the total book value of what was considered the worst of the JDC assets transferred to the partnerships was written off as uncollectible by the partnerships.

Furthermore, the recovery rate of the JDC GP is overstated because the calculation does not take into consideration the expense of pursuing collection on the assets, which was borne completely by the GP (except when the GP petitioned the LP for release of

Table I.17-3

Recovery Rate Achieved by the RTC for the JDC Equity Partnership Program
($ in Millions)

	LP	GP
Initial Contribution	$170.0[a]	$1.8[b]
Actual Collections to Date	$54.8	$54.8
Projected Collections	+18.6[c]	+9.6
Total, Actual and Projected Collections	**$73.4**	**$64.4**
Projected Recovery Rate	43.2%	3,577.8%[d]

a Estimated to be the corporate purchase amount, which is 1 percent of the book value of the underlying JDCs and 20 percent of the book value of the SBA assets at the time of delivery into the partnerships.

b Estimated to be 0.0101 percent of the book value for JDC assets and 0.20 percent of the book value of the SBA assets at the time of delivery into the partnerships.

c Includes estimated future RTC asset collection distributions as well as the expected distributions from the reserve account.

d This calculation does not include the expense of pursuing collection on the assets, which amount was paid solely by the GP, as these amounts are unknown.

Source: FDIC Division of Finance and Division of Resolutions and Receiverships.

funds in the reserve account to cover certain expenses, as described earlier). The actual amount of the expenses that the GP paid to pursue collections is not known.

Strengths and Weaknesses of Equity Partnerships

One strength of the equity partnerships was that carefully aligned financial incentives encouraged the GP to maximize return while minimizing the holding period of the assets. Those incentives created a single-mindedness between the LP and GP that minimized potential disputes and allowed them to concentrate their energies on getting the most value out of the underlying assets. Moreover, when the market for an asset was too thin or unstable or when asset-specific information was insufficient to allow the market to value an asset without factoring in a substantial risk premium, the equity partnerships provided an opportunity to capture the effects and benefits of market stabilization and better information.

Another advantage of the equity partnerships is that the RTC did not bear the full burden of due diligence and collection expenses. In addition, because the GPs were required to have independent CPA firms perform annual audits, the financial statements were credible. Also, by placing the difficult assets into the equity partnerships, the RTC asset marketing personnel were able to concentrate on loan or other asset sales for which a much greater return on book value was probable.

Experience in seller financing proved to save both time and money while promoting sales competition. RTC's offering of financing terms allowed bidders to place an offer much more quickly because they did not have to pursue third-party financing. The elimination of the expense of obtaining the financing made the transactions more cost-effective. It also allowed more investors to qualify and compete, thereby increasing demand and, as a result, prices.

However, although the equity partnerships worked well in a number of ways, they also had some weaknesses. One was that if the GP made a series of poor business decisions that ultimately placed the equity partnership in jeopardy, the LP could do little about that because that was part of the risk of doing business. Under the terms of the agreement, the LP had to show evidence of fraud or gross negligence before it could replace a GP. Should the LP interfere in the GP's business decisions without cause, the LP would have been considered to be acting as the GP and would have therefore lost its limited liability status. The LP did, however, review the GP's business plans and, acting in its limited capacity, offered suggested courses of action regarding certain assets or situations. In the end, though, the LP had to live with the GP's decisions.

Another weakness occurred when financial incentives became misaligned and tensions were created in the relationship between the GP and the LP. For example, in the JDC equity partnership structure, the GP was required to fund most of the expenses of the partnership. Although the JDC partnerships provided for a reserve account to be established to fund certain qualified asset-related expenses, the GP had to first request approval from the LP before using the reserve account funds. That situation strained the relationship between the GP and the LP at times because the LP was under no obligation to approve those requests.

Tables I.17-4, I.17-5, and I.17-6 summarize characteristics of equity partnerships.

Asset Management and Disposition Agreement Partnerships

The structure of the Asset Management and Disposition Agreement differs from the equity partnerships in certain key areas. For example, the assets contributed to the AMDAs were not subject to bidding in an open market environment, were made up of different asset portfolio mixtures, and were from a sole source, which was an original portfolio of a particular failed savings and loan. Such elements contrast with the equity partnerships, which held competitively bid pools of similar assets obtained from various failed institutions within a certain regional area or throughout the nation.

AMDAs were created by the RTC as a result of FIRREA.[16] FIRREA mandated the review, analysis, and possible renegotiation of certain 1988 and 1989 FSLIC assistance agreements that had been used as a vehicle to resolve failed thrifts. The RTC was to examine the possibility and means of restructuring the transactions in a manner that

16. Although the RTC was responsible for the renegotiation of the FSLIC assistance agreements, the FDIC as manager of the FSLIC Resolution Fund since the dissolution of the FSLIC in 1989 became the limited partner representing the public sector's interest in the AMDA agreements.

Table I.17-4

General Characteristics of the Equity Partnership Types

	Program Inception	Number of Partner-ships	Bonds?/ Bond Holder	Types of Underlying Assets	Target Investor/ Legal Structure	LP/GP Ownership Percentage
N Series	Dec. 1992	6	Yes/ Institutional investors via open market	Commercial and multi-family non-performing loans	Large Investors/ Trust	51/49
MIFs	Jan. 1993	2	No, but bond equivalent/ Held by RTC	Commercial and multi-family non-performing loans, REO	Large Institutional Investors/ Partnership	25-50/ 50-75
Land Funds	July 1993	12	No	Undeveloped and partially developed land (REO and non-performing loans)	Small Investors/ Partnership	60-75/ 25-40
S Series	Sept. 1993	9	Yes/Held by a trustee for the RTC	Commercial and multi-family non-performing loans	Small Investors/ Trust	51/49
JDCs	Dec. 1993	30	No	JDCs and small balance assets (SBAs)	Investors with collection experience/ Partnership	*
SN Series	Aug. 1995	5	Yes/Held by a trustee for the RTC	Commercial non-performing loans	Large and Small Investors/Trust	51/49
NP Series	Aug. 1995	8	Yes/Held by a trustee for the RTC	Non-performing land loans and land REO, unsecured loans or loans secured by non-real estate collateral (such as business loans), nonperforming commercial real estate and REO (commercial and multi-family)	Small Investors/ Trust	50-70/ 30-50

* The LP contributed 1 percent of the book value for JDCs and 20 percent of the book value for SBAs; the GP contributed 0.0101 percent of the book value for JDCs and 0.20 percent of the book value for SBAs.

Source: FDIC Division of Resolutions and Receiverships.

Table I.17-5

Financial Comparison of Equity Partnerships By Type

($ in Millions)

Equity Partnership Type	Original Book Value BV of Assets	Derived Investment Value (DIV) of Assets	RTC's Net Collections*	RTC's NPV of Net Collections†	NPV of Net Collections/ BV%	NPV of Net Collections/ DIV%
N Series	$2,782	$1,321	$1,664	$1,573	57	119
MIF Series	2,034	982	1,094	995	49	101
Land Funds	2,218	641	692	592	27	92
S Series	1,019	466	627	571	56	123
SN Series	440	225	275	254	58	113
NP Series	537	119	154	145	27	122
Totals	**$9,030**	**$3,754**	**$4,506**	**$4,130**	**46**	**110**

* RTC's collections are undiscounted; expenses have been paid by the partnership prior to the distribution of proceeds to the partners. These collections are composed of actual and projected proceeds through the estimated life of the equity partnerships.

† The net present value of net collections represents a three-year Treasury constant maturity rate per Federal Reserve Economic Data to date (actual proceeds through June 30, 1997) and 8 percent for all future proceeds.

Source: FDIC Division of Resolutions and Receiverships.

would reduce their costs on a net present value basis and to pursue those cost reductions for the U.S. taxpayer whenever possible.

In 1990, the results of the RTC's review of the FSLIC assistance agreements showed that the prepayment of financing notes, the write-down of asset book valuations, and the sale of stock warrants held by the FSLIC Resolution Fund (FRF) would provide the greatest savings. However, some assistance agreements were either too large or too complex to take those types of actions within the confines of the original agreement. In those cases, the RTC determined that the best alternative was to restructure the agreements to eliminate their inefficiencies, which primarily concerned the management and disposition of problem assets. In addition, the agreements linked tax-exempt yield maintenance with loss coverage on assets, thereby creating financial incentives to delay the disposition of assets.[17] To monitor the disposition efforts of the acquirer, the FSLIC had to establish extensive oversight to properly monitor the yield maintenance and loss coverage.

17. The acquirers were allowed to exclude from their taxable income the amount of assistance payments received from the FSLIC. At the same time, the acquirers were allowed to deduct from their taxable income the underlying expenses for which they received assistance payments. That situation allowed the acquirers to realize a financial return in the amount of their effective income tax rate for every assistance claim. Therefore, the FSLIC's assistance payments often had a higher after-tax rate of return for the acquirers than did the acquirer's share of recoveries on the sale of assets covered under the assistance agreement (covered assets). It was therefore more financially beneficial to the acquirers to hold covered assets than to sell them and reinvest in taxable instruments.

Table I.17-6

Listing of Equity Partnerships

Equity Partnership Type	Name of Equity Partnership	General Partner	Original Book Value ($ in Millions)
N Series	1992 N-1	BT, Sterling, Amresco, American Securities, Soros	$346
	1993 N-1	N. P. Partnership II, Co.	618
	1993 N-2	AEW/J.E. Roberts/Secured Capital	743
	1993 N-3	BT, Sterling, Amresco, American Securities	324
	1994 N-1	BT, Sterling, Amresco, American Securities	406
	1994 N-2	BT, Sterling, Amresco, American Securities	345
	6	Subtotal	$2,782
MIF Series	MIF Realty, LP	MIF GEN-PAR, L.P.	$1,021
	Eastrich MIF, LP	MIF Holding, L.P.	1,013
	2	Subtotal	$2,034
Land Funds	Land Fund I – West Coast Land Fund	West Coast Equity, L.P. (Colony Capital)	$416
	Land Fund I – Sun NLF	Sun Partners	981
	Land Fund I – Sunchase Estrella	Estrella Sun	295
	Maco III – NLI/PLC/ MACO LP	NLI/PLC/Maco III Assoc. (National Loan Investors)	47
	Maco III – Tennessee Land Investors LP	CRT Land Investors – I, L.P.	14
	Maco III – Potomac Maco LP	Potomac Mid-Atlantic Partners, L.P.	96
	Land Fund II – National Land Investors LP	NLI Land Associates (National Loan Investors)	57
	Land Fund II- Overland Land Fund II LP	Overland Land Fund II	118
	Land Fund II – Dallas I LP	Mortgage Recovery Fund – Land Fund Dallas, L.P.	52
	Land Fund II – Colorado/New Mexico Land LP	Midland Asset Limited Partnership	29

Table I.17-6

Listing of Equity Partnerships
Continued

Equity Partnership Type	Name of Equity Partnership	General Partner	Original Book Value ($ in Millions)
Land Funds (cont.)	Land Fund II – Land Fund II LP	Mortgage Resolution Corporation	$29
	Land Fund II – COMAC Land LP	COMAC West Partners, L.P.	84
	12	Subtotal	$2,218
S Series	1993 S-1	AIG/Ontra I Associates	$74
	1993 S-2	1993 S-2 Investors, L.P.	112
	1994 S-1	T.K. 1994 S-1, Inc.	100
	1994 S-2	1994 S-CA Investors, L.P.	90
	1994 S-3	T.K. 1994 S-3, Inc.	38
	1994 S-4	AIG/Ontra II Associates	133
	1994 S-5	Baupost Realty/J.E. Roberts Co.	107
	1994 S-6	1994-S Dallas Associates, L.P.	84
	1994 N3/S	AIG/Ontra III Associates	281
	9	Subtotal	$1,019
JDCs	ARS Limited Partnership	American Recovery Systems, Inc.	$162
	Asset Recovery Services, Inc.	Asset A.R.M.S., L.L.C.	128
	JDC Partners, L.P.	BJF/IB Partners	156
	CDC Debt Recovery	CDC Debt Recovery Group, Inc.	160
	CVS/JDC Limited Partnership	Chotin-Vargas/Signet, L.L.C.	814
	CNF 1st Associates, L.P. I	CNF Texas, L.P.	408
	CNF 1st Associates, L.P. II	CNF California, L.P.	635

Table I.17-6

Listing of Equity Partnerships
Continued

Equity Partnership Type	Name of Equity Partnership	General Partner	Original Book Value ($ in Millions)
JDCs (cont.)	Emerson/Checkrite Fed. Recoveries	Emerson/Checkrite Federal Recoveries	$272
	Government Financial Svcs., L.P.	Government Financial Services	298
	Hudson, Marshall & Stallings, Inc.	Hudson, Marshall & Stallings, Inc.	103
	Investors Collection Svcs., L.P.	Investors Collection Services, Arizona J.V.	441
	MDA/Bain, L.P.	MDA/Bain Limited Partnership	250
	PNL Texas, L.P.	PNL Credit Company, L.L.C.	792
	PNL Southwest, L.P.	PNL Southwest, L.L.C.	113
	Premier Financial Svcs., East	Premier Financial Services, East	175
	Premier Financial Svcs., Texas	Premier Financial Services, Texas	511
	Premier Financial Svcs., West	Premier Financial Services, West	301
	JDC Finance Company, I	Prentiss/FMRC Joint Venture	515
	JDC Finance Company, II	Prentiss/FMRC Joint Venture	348
	JDC Finance Company, III	Prentiss/FMRC Joint Venture	840
	Recoveredge, L.P.	Recoveredge Joint Venture, L.L.P.	571
	Regional Financial Svcs., L.P.	Regional Financial Services, L.L.C.	431
	Republic Credit One, L.P.	Republic Credit Corporation	445
	RER-JDC Limited Partnership	RER Collections, Inc.	422

Table I.17-6

Listing of Equity Partnerships
Continued

Equity Partnership Type	Name of Equity Partnership	General Partner	Original Book Value ($ in Millions)
JDCs (cont.)	Stonehenge/FASA Texas JDC LP	Stonehenge/FASA JV #7	$523
	TCCP California L.P.	Telacu/Carpenter Collection Partners	640
	TCCP Texas L.P.	Telacu/Carpenter Collection Partners	332
	The Reliant Group, L.P.	The Reliant Group	746
	United Collections	United Collections	158
	Value Recovery Group, L.P.	Value Recovery Group Joint Venture I	728
	30	Subtotal	$12,418
SN Series	1995 S/N 1	1995 S/N 1 Investment Limited Partnership	$90
	1995 S/N 2	Chillicothe Properties, Inc.	81
	1995 S/N 3	AIG/Ontra V Associates	87
	1995 S/N 4	AIG/Ontra V Associates	119
	1995 S/N 5	Chillicothe Properties, Inc.	63
	5	Subtotal	$440
NP Series	1995 NP1A	Fourteenth RMA Partners, L.P.	$83
	1995 NP1B	PNL NP1 L.P.	71
	1995 NP2A	Value Recovery Group, L.L.C.	64
	1995 NP2B	PNL Whiteacre L.P.	127
	1995 NP2C	Mortgage Recovery Fund – 1995 NP2C, L.P.	38
	1995 NP3-1	1995 NP3-1 Investment Limited Partnership	62
	1995 NP3-2	AIG/Ontra VI Associates	51
	1995 NP3-3	Phoenician Investment, L.L.C.	41
	8	Subtotal	$537
Total	72		**$21,448**

Note: The JDC program is the only equity partnership structure that allows additional assets to be transferred to the partnerships after the consummation date. As such, the book values for the JDC partnerships reflect the assets transferred to the partnerships through September 30, 1997.

Source: FDIC Division of Resolutions and Receiverships.

The RTC concluded that to successfully redesign the assistance agreements, an alignment had to be made between the financial incentives of the private-sector parties to the original assistance agreement (the acquirers) and the FDIC. The RTC also determined that it was important to spread risk among the parties and to minimize any governmental oversight of the acquirers that might hinder their initiative and slow down the day-to-day decision-making process.

Evolution and Structure of the AMDA

The AMDA partnership structure was designed so that both the acquirer (GP) and the FDIC (LP) would have equity at risk. The GP's private investors, in addition to contributing to the partnership's capital, accepted responsibility for managing and disposing of the partnership's assets. In return, the GP received distributions from the net recovery on the partnership's assets, but received no management fee. Instead of receiving a management fee, the GP deducted all direct expenses, including its staff and operating expenses that were devoted 100 percent to the asset portfolio, from gross collections before distribution to the partners. Overhead and indirect costs, however, were borne entirely by the GP.

The first AMDA, known as Mountain AMD L.P. (Mountain), closed on January 31, 1993. Mountain was the product of the renegotiations of the FSLIC-assisted acquisition of Columbia Savings and Loan, Englewood, Colorado, as well as other failed thrifts, by First Nationwide Bank (First Nationwide), San Francisco, California, a wholly owned subsidiary of the Ford Motor Company. At closing and on April 30, 1993, the FDIC as LP contributed assets equal to $339.8 million to the Mountain partnership. The GP, FN Realty Advisors, Inc. (FNRAI), invested $23.2 million in capital, equaling 6.8 percent of the value of the assets, to the Mountain partnership.[18,19] Approximately $9.3 million of the GP's investment was in cash, and $13.9 million was financed by the FRF. The duration of the Mountain AMDA was set at five years with the option to extend for one year if both parties agreed.

The second AMDA, Brazos Partners, L.P. (Brazos), was formed on June 30, 1993. It was a renegotiation of an assistance agreement completed in 1988 by the FSLIC for the

18. In mid-1994, FNRAI sold, with the approval of the FDIC, its GP interest in the Mountain partnership to Little Muddy Creek Corporation, a U.S. subsidiary of Internationale Nederlanden Bank, N.V., a Netherlands bank.

19. The FRF financed a certain percentage (60 percent for Mountain and 65 percent for Brazos Partners, L.P. [Brazos]) of the GP's capital contribution. That debt bore interest at 9 percent and was payable out of the distributions to the GP. A minimum of 60 percent of Mountain's GP distribution had to go toward the retirement of the debt; 65 percent was the minimum required for Brazos. The seller financing was nonrecourse except that it would be a priority claim on distributions should the partnership be terminated before payoff of the capital loan. Those debts were repaid by the GP more quickly than was required.

failed American Savings, a FS&LA, Stockton, California. The FDIC, as manager of the FRF, agreed to repurchase assets from the acquirer, New West FS&LA, and contributed them as LP to the Brazos partnership. The assets portfolio contributed by the LP was valued at $1.3 billion. Brazos's private investors (Brazos Asset Management, Inc. [BAM], acting as GP, and Brazos Fort, L.P., and Brazos Worth, L.P., the investor LPs) contributed about $134.4 million to the partnership.[20] That contribution included approximately $40 million in cash, $18.8 million of which was in the form of a credit by the FDIC (as the result of the assumption of a FSLIC liability to one of the acquirers of American Savings Bank, F.A.), and $75.6 million provided through financing by the FRF.[21] Brazos's investment equaled about 10.1 percent of the value of the assets. Like the Mountain AMDA, the duration of the Brazos AMDA was set at five years with the option to extend for one year if both parties agreed. Chart I.17-8 illustrates the structure of the AMDA partnership.

The value of the assets were initially determined by a mark-to-market valuation performed by third-party investment bankers using the AMDA's modified version of the DIV methodology, which differed from the RTC's methodology because it specified narrower ranges and parameters. The assets were recorded on the books of the partnerships at a negotiated price determined in reference to the mark-to-market values established by the investment bankers.

Assets were transferred to the two AMDA partnerships without representations or warranties provided by the FDIC. The partnerships assumed any outstanding legal or environmental liabilities, as well as any potential lender liabilities. An adjustment was made in the valuation of the assets to account for those assumed liabilities.

As shown in table I.17-7, Brazos liquidated its portfolio much more rapidly than Mountain did. Although Mountain exhibited a slower disposition rate, it achieved a higher recovery ratio on the assets in its portfolio. As of March 31, 1997, the AMDA partnerships' recovery ratios were calculated to be 157 percent for Mountain, in contrast with 132 percent for Brazos.[22]

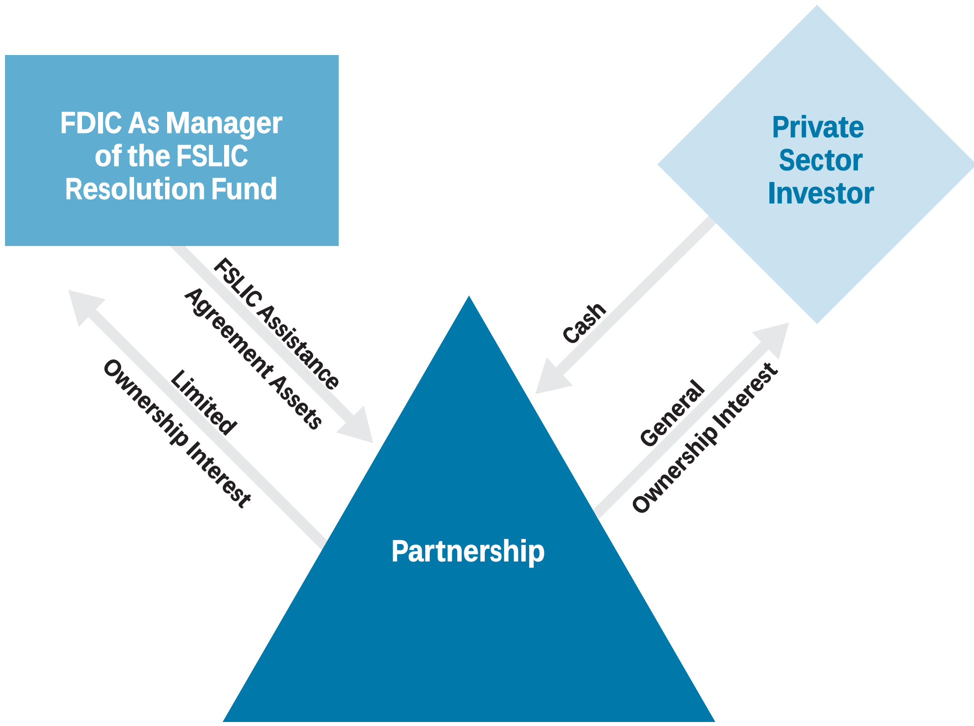
20. On December 28, 1988, the FSLIC executed one of its largest 1988 transactions with and among Keystone Holdings, Inc.; New American Holdings, Inc.; New American Capital, Inc.; American Savings Bank, F.A.; Stockton, California (New American); and New West FS&LA, Stockton, California (New West). It executed the assistance agreement in connection with the transfer of substantially all of the assets and liabilities of American Savings, a FS&LA, Stockton, California, to New American, New West, and the American Real Estate Group.

21. See footnote 19.

22. The recovery ratio equals the accumulation of all cash flows (net funds collected and distributed) at a given time divided by the initial marked value of the pool to determine the percentage of marked value achieved. The cash flow and the initial value are adjusted by a 9 percent annual indexing factor that is designed to help eliminate the incentive to delay the liquidation of assets awaiting increases in value as a result of inflation or other market factors.

Chart 1.17-8

Structure of AMDA Partnership



Source: FDIC Division of Resolutions and Receiverships.

Partnership Distribution Structure

The partnership distribution structure of the AMDA partnerships was designed to align the private sector's financial interests with the government's goal of maximizing the net present value of recoveries from the management and disposition of problem assets. Partnership distributions were calculated using predetermined tranches based on the ratio of cumulative recoveries to initial marked value. For example, until the time when the GP had achieved cumulative recoveries of up to 60 percent of the initial marked value, the Mountain GP received only 2 percent of the net distributions of the asset recoveries, and the Brazos GP received only 6.5 percent. When the Mountain GP achieved 100 percent of the portfolio's initial marked value, however, it would have received 9.2 percent of the total partnership distributions on an equity investment of 6.8 percent. Likewise, the Brazos GP would have received 13.25 percent of the total partnership distributions on an equity investment of 10.1 percent. (See table I.17-8.)

Table I.17-7

Disposition of AMDA Assets and FDIC's Collections Cumulative, Per Year

($ in Millions)

	Mountain				Brazos			
Years into AMDA	Cumulative Assets Sold	Cumulative Percentage Sold	FDIC's Net Collections	Percentage of FDIC's Total Net Collections	Cumulative Assets Sold	Cumulative Percentage Sold	FDIC's Net Collections	Percentage of FDIC's Total Net Collections
Year 1	$63.2	18.6	$127.4	23.9	$1,025.0	77.0	$1,240.2	77.9
Year 2	177.0	52.1	319.4	59.9	1,251.3	94.0	1,525.5	95.8
Year 3	286.5	84.3	477.2	89.4	1,312.6	98.6	1,579.9	99.2
Year 4	315.0	92.7	522.2	97.9	1,315.2	98.8	1,587.1	99.6
Year 5 *	339.8	100.0	533.5	100.0	1,331.2	100.0	1,592.8	100.0

* Year 5 includes projected asset sales and collections through the estimated life of each partnership.

Sources: FDIC Division of Resolutions and Receiverships and financial statements of Mountain and Brazos.

Table I.17-8

AMDA Compensation Schedule

AMDA Agreement	Recovery Ratio* Tranche	GP's Distribution Percentage	LP's Distribution Percentage
Mountain	0 to 60%	2	98
	Greater than 60% to 135%	20	80
	Greater than 135%	10	90
Brazos	0 to 50%	6.5	93.5
	Greater than 50% to 135%	20	80
	Greater than 135%	10	90

* See footnote 22.

Source: FDIC Division of Resolutions and Receiverships.

In general, the recovery ratio tranches were designed to motivate the GP to maximize recoveries by providing a direct financial incentive to work the assets. An important objective of the tranche structure was to ensure that the GP had a financial stake in the marginal income or loss resulting from any business decision it made. The tranche structure allowed the government to receive a majority of the proceeds during the early stages of the partnership's life, when proceeds are the most certain. The second tranche provided the greatest possible distribution of 20 percent to the GP, and a recovery at that level should be the most likely outcome. If recoveries of more than 135 percent were achieved, the GP's distribution would fall to 10 percent. The last tranche was structured so that if a recovery at that level was achieved (which could happen if the initial marked value of the assets was too low), the LP would get most of the profit. The last tranche was designed as a self-correcting mechanism to ensure that the GP would not be unduly enriched, yet would still be provided with a respectable return.

Expense Reimbursement

Initially, the FDIC advanced funds to the GP as working capital to cover the initial expenses of the partnership. After the cash flow became positive, the GP quickly repaid the advance. After the repayment, all expenses related to the partnership would be paid from the cash generated by the partnership from sales of properties and settlements of loans. Any staff whose salaries were charged to the partnership had to be devoted exclusively to the operations of the partnership. No affiliated transactions of any kind were allowed unless the FDIC, as LP, approved them.

Compliance Standards

The AMDA GPs were prohibited from engaging in speculative disposition strategies for the assets. The partnership could not change the nature of an asset it received; for example, it could not turn raw land into developed lots. Capital expenditures for an individual asset were limited to 10 percent of the asset's initial valuation. The GP could not sell assets to related parties, engage in affiliate transactions, give representations and warranties beyond the term of the partnership, admit new partners, or engage in transactions of any kind that were unrelated to the partnership's business.

Government Oversight

Although the GP was fully responsible for the operations of the partnership, the LP had the right (at its own expense) to audit the operations of the partnership on an after-the-fact basis. The AMDA also required the GP to obtain annual financial audits of the partnership and to file its own tax returns. In addition, the OIG and GAO had the right to perform audits on the partnership and its related transactions at any time.

To resolve disputes in a rapid manner and with the least harm to the partnership, the AMDA allowed for the creation of a binding three-person dispute resolution panel when disputes or issues arose between the partners or when there were any violations of the terms of the partnerships. That panel would contain a neutral party and one member each from the LP and GP, each of whom was selected by the LP and GP. In the event of a compliance violation, the panel had the right to impose a monetary penalty upon the GP. If the actions of the GP were so serious as to cause harm to the financial viability of the partnership, the FDIC as LP had the right to seek dissolution of the partnership and distribute the proceeds from the liquidation of any remaining partnership assets.

Measuring the Success of the Partnerships—Recovery Results

From the inception of the agreement to September 30, 1997, the Mountain partnership had distributed a total of $603 million to the partners; of that amount, the GP received $73.5 million and the FDIC as LP received $529.5 million. When Mountain's remaining assets are sold, the FDIC expects to receive an additional $4 million.

For the same period, the Brazos partnership had distributed a total of $1.8 billion to its partners: the GP received $13.1 million, the investor LPs (Brazos Fort and Brazos Worth) got $223.5 million, and the FDIC as LP received $1.6 billion. The FDIC expects to receive an additional $5.7 million when the remaining Brazos assets are sold.

Any comparison drawn between the two AMDA partnerships could be misleading. The two partnerships differ in distribution structure (tranche levels), derivation of initial asset valuations (each had an independent negotiation), and composition of asset portfolio (the asset pools and geographic locations were not identical). In addition, several other differences between the two partnerships must be considered.

First, each AMDA partnership was an extension of the resolution efforts begun under individual FSLIC assistance agreements. The GP's previous dealings with those assets under their assistance agreement may have affected the results of the AMDA partnership efforts. For example, the GP of Brazos (the former acquirer of the New West assistance agreement) had received $3.2 billion in FSLIC assistance payments before the transfer of the assets into the AMDA. The GP of Mountain (the former acquirer of the First Nationwide assistance agreement) had received $2.9 billion in FSLIC assistance payments.[23,24]

23. At the start of the New West assistance agreement, the acquirer received $21.4 billion in book value of assets. During the term of the assistance agreement, the acquirer disposed of assets with a book value of approximately $18.8 billion, leaving $2.6 billion to be marked to market and transferred into the Brazos AMDA.

24. The acquirers of the First Nationwide assistance agreement received $4.9 billion in book value of assets at the inception of the agreement. They liquidated about $4.2 billion during the course of the agreement, leaving $738 million to be marked to market and transferred into the Mountain AMDA.

Second, the initial book value of the assets for each of the AMDA partnerships was determined by a mark-to-market valuation performed on the remaining assets in each of the FSLIC assistance agreements. The mark-to-market valuation was negotiated as part of a complex termination agreement entered into by each GP to end the provisions of their FSLIC assistance agreement.[25] Therefore, the valuation methodology of the initial AMDA book value was greatly affected by the "give and take" of the individual negotiations.

Finally, the asset portfolios transferred into each of the AMDAs were not similar. For example, the Brazos portfolio was four times the size of the Mountain portfolio. In addition, the Brazos portfolio was concentrated in California, a declining market, while the Mountain portfolio was situated in Colorado, a market that was experiencing a recovery. Without complex adjustments to account for the effects of the local markets in which the portfolios were located, it is difficult to determine which portion of the asset recoveries was achieved because of the success of the partnership.

The most basic method of analysis is the net rate of recovery on the book value (recovery rate) of the assets transferred into the partnerships. That analysis is attractive because the recovery rate information is readily available for each of the transactions. The recovery rate is calculated in this discussion in two ways. Table I.17-9 shows the percentage of the FDIC's net proceeds from the transaction divided by the initial unmarked book value of the assets from the FSLIC assistance agreements before their transfer to the AMDAs. Table I.17-10 shows those same net proceeds divided by the AMDA negotiated mark-to-market valuation.

To properly compare the two AMDAs on the basis of the historical book value of the assets before the negotiated mark as shown in table I.17-9, the effects of the dissimilarities between the asset type and market location of their underlying asset pools must be taken into account. The general drawbacks to the recovery rate as a percentage of book value methodology already noted in the equity partnership portion of this chapter also apply to this AMDA analysis.

A comparison between the two AMDAs on the basis of the recovery rate as a percentage of marked book value as shown in table I.17-10 is subject to the same considerations as were the comparisons of derived investment value presented for the equity partnerships earlier in this chapter. To analyze the results of the return on marked book value, it is important to consider the negotiated mark-to-market process. In addition, the same concerns about the dissimilarities between asset type and market location that are present in the historic book value analysis are present in the negotiated mark-to-market value analysis.

25. Some portions of the FSLIC assistance agreements survived the termination process.

Table I.17-9

AMDA Recovery Rates Achieved by the FDIC Stated As a Percentage of Unmarked Book Value*

($ in Millions)

	Actual and Projected Net Collections	Unmarked Book Value	Collections as a Percentage of Unmarked Book Value
Mountain	$533.5	$740.8	72%
Brazos	1,592.8	2,947.6	54%

* The unmarked book value is that of the assets transferred from the FSLIC assistance agreement to the AMDA partnership before the initial mark-to-market valuation. FDIC recoveries represent undiscounted actual proceeds received through September 30, 1997, and estimated future recoveries. All receipts are net of expenses, which are paid by the partnership before distribution. This recovery rate analysis does not use the 9 percent indexing factor for determining the recovery ratio tranches. Recoveries do not reflect the FRF financing provided to the GP.

Sources: FDIC Division of Resolutions and Receiverships, financial statements of Mountain and Brazos, and AMDA settlement documents.

Table I.17-10

AMDA Recovery Rates Achieved by the FDIC Stated As a Percentage of Marked Book Value*

($ in Millions)

	Actual and Projected Net Collections	Marked Book Value	Collections as a Percentage of Marked Book Value
Mountain	$533.5	$339.8	157%
Brazos	1,592.8	1,331.2	120%

* The marked book value is the negotiated mark-to-market valuation of the AMDA partnerships. FDIC recoveries represent undiscounted actual proceeds received through September 30, 1997, and estimated future recoveries. All receipts are net of expenses, which are paid by the partnership before distribution. This recovery rate analysis does not use the 9 percent indexing factor for determining the recovery ratio tranches. Recoveries do not reflect the FRF financing provided to the GP.

Sources: FDIC Division of Resolutions and Receiverships and financial statements of Mountain and Brazos.

Strengths and Weaknesses of AMDAs

One strength of the AMDAs was the distribution structure for recoveries, which allowed the FDIC to participate in the upside potential of the mainly nonperforming assets. In particular, the FDIC benefited substantially from that structure in the Mountain AMDA because of the rising Colorado real estate market.

The AMDA was designed so that the private-sector entity had at least a 20 percent marginal income or loss in any business decision made by the GP, even though its equity position overall was substantially less than 20 percent. That design imposed a risk feature that should motivate the GP to act in the best interest of the partnership. As a result, full management control was placed into the hands of a private party whose financial objective was clear—obtaining the highest net present value recovery from the disposition of the assets.

An important element of the AMDA structure was the binding dispute resolution panel to resolve disputes. The purpose of the panel was to limit protracted legal activity between the partners that would drain time, attention, and monetary resources away from the day-to-day activities of the partnership, thereby ultimately harming the recoveries to all parties.

One aspect of the AMDA structure that caused concern was that certain expenses, including personnel costs for staff dedicated exclusively to the operations of the partnership, were subject to the sharing percentages of the tranche structure. The FDIC as LP therefore would pay 80 percent of those expenses in the optimal tranche. The GP had the authority to determine what the partnership would pay for such items as salaries, and the FDIC as the passive LP had to bear the majority of the expense.

Conclusion

Altogether, the RTC and FDIC conveyed assets that had an aggregate book value of more than $25 billion to partnerships in which they held an interest. Almost half of this amount was sold to JDC partnerships, in which the agencies' primary goals were to place the assets with firms having collection expertise and to share in any unforeseeable recoveries. The remaining half comprises assets contributed to six different equity partnership programs, each targeted for use with distinct asset and investor types, and two AMDA agreements that were a result of renegotiated FSLIC assistance agreements. For all the partnership programs the agencies' primary objectives were to capture the expertise and efficiency of the private sector and to share in the profit achieved from greater market efficiency.

It is difficult, if not impossible, to state which of the seven equity partnership structures worked "best," because each evolved quickly in dynamic markets for different purposes and with different asset types. However, two design features of the equity partnerships may have contributed to increasing present value recovery. RTC recoveries were generally higher for structures that conveyed smaller sized pools and for structures that had specifically identified assets at the time of bidding rather than those featuring blind pools.

As shown by the RTC and FDIC experience, equity partnerships can be used as a vehicle to convey a large volume of assets to private-sector management in a relatively short period of time. They also can be used for a variety of asset types, for assets of varying quality, and for different investor profiles. Depending on the agency's objectives, the amount of cash obtained at closing relative to future collections can vary. Furthermore, the partnership's ownership structure can be created under several different legal forms, and the seller can hold varying degrees of residual interest.

The RTC and FDIC exchanged the certainty and benefits arising from a complete divestment of ownership for potentially greater recoveries. The agencies, in addition to continuing to bear market risk, incurred ongoing costs for monitoring partnership activities and managing their residual interests. Also, although the structures were designed to shield the passive interest holder from liability arising from legal claims associated with assets held in the partnership, they did not fully exculpate the agencies from pressures that arise from their public status. Nonetheless, the recovery results suggest that the RTC achieved higher recoveries through equity partnerships than through other multiple-asset sales methods it used.

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To effectively handle the tremendous volume of legal matters resulting from the rising number of failing financial institutions, the FDIC increasingly turned to outside counsel.